



## STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

# DRAFT

Date Introduced:	01/18/11	Bill No:	<a href="#">Assembly Bill 155</a>
Tax Program:	Use Tax	Author:	Calderon
Sponsor:	Author	Code Sections:	RTC 6203, 6208, & 7055
Related Bills:	AB 153 (Skinner) SB 234 (Hancock) SB 655 (Steinberg)	Effective Date:	01/01/12

### BILL SUMMARY

This bill would do all the following:

- Specify that any out-of-state retailer that has substantial nexus with this state for purposes of the Commerce Clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty is a “retailer engaged in business in this state.” (Section 6203(c))
- Specify that a retailer that is a member of a commonly-controlled group and a member of a combined control group that includes another member of the retailer’s commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer performs services in this state in connection with tangible personal property to be sold by the retailer, as specified, is a “retailer engaged in business in this state.” (Section 6203(c)(3))
- Delete the provisions that among other things, excludes from the term, “engaged in business in this state” the taking of orders from customers in this state through a computer telecommunications network located in this state which is not directly or indirectly owned by the retailer when the orders result from the electronic display of products on the same network. (Section 6203(4) and 6203(5))
- Require retailers that are not engaged in business in this state that sell tangible personal property to California consumers to provide information about use tax on its Internet site and any retail catalog (Section 6208) and to provide specified information to the BOE and customers. The bill would also penalize retailers for failing to comply. (Section 7055)

### ANALYSIS

#### CURRENT LAW

Under federal law, Article I, Section 8, Clause 3 of the United States Constitution, known as the Commerce Clause, states that Congress has the exclusive authority to manage trade activities between the states, with foreign nations, and Indian tribes. The "Dormant" Commerce Clause, also known as the "Negative" Commerce Clause, is a legal doctrine that courts in the United States have implied from the Commerce Clause. The idea behind the Dormant Commerce Clause is that this grant of power implies a negative converse — a restriction prohibiting a state from passing legislation that improperly burdens or discriminates against interstate commerce. The question of to

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what extent states can legally compel remote retailers to collect the tax, however, has been a subject of extensive disagreement.

Under California's Sales and Use Tax Law, Chapter 3 (commencing with Section 6201) of Part 1 of Division 2 of the Revenue and Taxation Code, a use tax is imposed on the storage, use, or other consumption in this state of tangible personal property purchased from any retailer. The use tax is imposed on the purchaser, and unless that purchaser pays the use tax to a retailer registered to collect the California use tax, the purchaser is liable for the tax, unless the use of that property is specifically exempted or excluded from tax. The use tax is the same rate as the sales tax and is generally required to be remitted to the BOE on or before the last day of the month following the quarterly period in which the purchase was made, or a purchaser may report the tax on the purchaser's state income tax return (if that purchaser is not registered with the BOE).

Section 6203 of the Sales and Use Tax Law describes various activities that constitute "engaging in business in this state" for purposes of determining whether an out-of-state retailer has sufficient business presence (also known as "nexus") in California such that the state will impose a use tax collection responsibility on sales made to California consumers. If a retailer has sufficient nexus within the terms of Section 6203, that retailer is required to register with the BOE pursuant to Section 6226 and collect the applicable use tax on all taxable sales to California consumers.

Under Sales and Use Tax Section 7055, in administration of the use tax, the BOE may require the filing of reports by any person or class of persons having in his or their possession or custody information relating to sales of tangible personal property the storage, use, or other consumption of which is subject to the tax. The reports are required to be filed when the BOE requires and are required to set forth the names and addresses of purchasers of the tangible personal property, the sales price of the property, the date of sale, and such other information as the BOE may require.

#### **PROPOSED LAW**

This bill would amend Revenue and Taxation Code Section 6203 to do the following:

- Specify that a "retailer engaged in business in this state" means any retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty.
- Specify that a retailer that is a member of a commonly-controlled group and a member of a combined control group that includes another member of the retailer's commonly controlled group that, pursuant to an agreement with or in cooperation with the retailer performs services in this state in connection with tangible personal property to be sold by the retailer, as specified, is a "retailer engaged in business in this state."
- Delete the provision that would become operative upon a specified congressional act that specifies that any retailer soliciting orders for tangible personal property by mail if the solicitations are substantial and recurring and if the retailer benefits from any banking, financing, debt collection, telecommunication or marketing activities occurring in this state or benefits from the location in this state of authorized installation, servicing, or repair facilities.

- Delete the provision that excludes the taking of orders from customers in this state through a computer network located in this state which is not owned by the retailer when the orders result from the electronic display of products on that same network, as specified.

The bill would also add Section 6208 to the Revenue and Taxation Code to require each out-of-state retailer that is not required to collect the use tax who makes taxable sales in California, to provide readily visible notice on its retail Internet Web site and any retail catalog that use tax is imposed on the storage, use or other consumption of tangible personal property purchased from the retailer that is not exempt from tax, and that tax is required to be paid by the purchaser.

In addition, the bill would amend Section 7055 of the Revenue and Taxation Code to do the following:

- Require every person that is not registered with the BOE that sells tangible personal property, the storage, use, or other consumption of which is subject to use tax, to file with the BOE a report annually of the names and addresses of purchasers of the property, the sales price, date of sale, and other relevant information as the BOE may require.
- Exclude any person whose receipts from those sales are less than \$500,000 in the prior calendar year and are reasonably expected to be less than \$500,000 in the current year.
- Impose a penalty of \$10 per violation for each name of a purchaser that was not included in the report for each annual period.
- Require each person annually to send a notice to each purchaser showing the total amount of purchases made by that purchaser in the prior calendar year. Also, the bill would require the notice to inform the purchaser of the obligation to file the appropriate sales and use tax returns and require the notice be sent by first-class mail, as specified.
- Impose a penalty of \$10 per violation for each purchaser to whom a notice is not sent.
- Require the BOE to relieve either penalty if the BOE finds that the person's failure to comply is due to reasonable cause and circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect.

#### **BACKGROUND**

One of the greatest controversies in the field of state taxation today concerns the constitutional authority of the states to impose a use tax collection responsibility on out-of-state retailers for the sale of goods shipped into the taxing state. Such transactions are generally conducted either through mail order, telephone orders, or via the Internet.

A December 2010 BOE estimate of uncollected use tax reveals that about \$1.145 billion goes unpaid annually (\$795 million in uncollected use tax from California consumers; \$350 million from businesses). The estimate indicates that the unpaid use tax liability owed by the average California household is \$61 per year and \$102 per year for each California business.

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Under constitutional law, states lack jurisdiction to require out-of-state retailers to collect a sales or use tax when the retailer has no "physical presence" in the taxing state. In 1992 the Supreme Court issued an opinion in *Quill Corporation v. North Dakota* (1992) 504 U.S. 298 and held that satisfying due process concerns does not require a physical presence, but rather requires only minimum contacts with the taxing state. Thus, when a mail-order business purposefully directs its activities at residents of the taxing state, the Due Process Clause does not prohibit the state's requiring the retailer to collect the state's use tax. However, the Court further held that physical presence in the state was required for a business to have a "substantial nexus" with the taxing state for purposes of the Commerce Clause. The Court therefore affirmed that in order to survive a Commerce Clause challenge, a retailer must have substantial nexus in the taxing state before that state can require the retailer to collect its use tax.

Since the late 1990s, online shopping has taken off as an increasing number of businesses and consumers purchase increasingly diversified products on the Internet. That, combined with the states' inability to require a use tax collection requirement on many out-of-state retailers, has prompted many states to seek new ways to enforce their use tax laws (every state that has a sales tax imposes the use tax). In California, for example, ABx4 18 was enacted in 2009 to require all businesses that have gross receipts from business operations of at least \$100,000 annually and that are not already required to be registered with the BOE to register and file an annual use tax return to report and pay the applicable use tax on their untaxed purchases.

Colorado enacted legislation that became effective in March 2009. Colorado's law and accompanying regulations require a reporting requirement for Internet sellers (similar to this bill), including:

- Invoices to Colorado customers must note that use tax applies to taxable purchases and must be reported by the purchaser.
- An annual report must be provided to their Colorado customers on all purchases.
- An annual report must be filed with the Colorado Department of Revenue with customer names and addresses and total amount of purchases.

Colorado's law also provides for a penalty of \$5 per invoice without use tax information, and \$10 penalty per failure to provide annual customer reports. Colorado's emergency regulation related to these provisions specifies that out-of-state retailers that made total gross sales in the prior year of less than \$100,000 and reasonably expects sales in the current year will be less than \$100,000 shall be exempt from these requirements.

*(However, a preliminary injunction sought by the Direct Marketing Association from the U.S. Federal District Court was granted by the Court on January 26, 2011, and Colorado is now prohibited from enforcing these provisions. The Court ruled that these provisions, in effect, provide a geographic distinction between in-state and out-of-state retailers which discriminates patently against interstate commerce, and that these provisions impose burdens on out-of-state retailers who have no connection with Colorado customers other than by common carrier or the United States mail, and that those retailers likely are protected from such burdens on interstate commerce by the safe-harbor established in Quill.)*

**Past related legislative efforts.** In the 2007-08 Legislative Session, two bills similar to the proposed changes in Section 6203(c) – extending nexus to the extent allowed under the U.S. Constitution and federal law - were introduced by Assembly Member Calderon: AB 1840 and ABx3 2. AB 1840 failed passage on the Assembly floor and ABx3 2 was never heard in committee.

During the 2009-10 Session, Assembly Member Calderon introduced a measure that would have imposed an information reporting requirement on out-of-state retailers without California nexus, without the imposition of any penalty. That measure, AB 2078, was subsequently amended to delete the information reporting requirement, and simply require out-of-state retailers without California nexus, to post information on their Internet websites and catalogs about use tax, and with only that provision remaining, died on the Senate Floor.

## COMMENTS

1. **Sponsor and Purpose.** This bill is sponsored by the author to enforce California's Use Tax Law to the fullest extent allowed in order to close the over \$1 billion use tax gap.
2. **What does the "long-arm" provision (proposed Section 6203(c)) accomplish?** This provision would impose a use tax collection obligation on any out-of-state retailer that has nexus in California when it makes taxable sales to California consumers. This would include other activities that have passed constitutional muster in other states, and would also eliminate any restrictions in the nexus provisions in current law. For example, in over 20 states, including New York, Minnesota, and Louisiana, repair or warranty services performed by third party independent contractors in connection with items sold by out-of-state retailers under certain circumstances create nexus for those out-of-state retailers. Also, some states impose a use tax obligation on out-of-state retailers that sell the same or substantially similar line of products as the retailer maintaining sales locations in the taxing state under the same or substantially similar business name. In addition, a 2008 change in New York's statutes that imposes a use tax collection obligation on out-of-state retailers that have affiliate programs with New York residents under specified circumstances has been reviewed by New York's appellate court and deemed constitutional on its face. As such, this "long-arm" nexus provision would provide California with the tools it needs to allow for use tax collection to the fullest extent federal law and the U.S. Constitution permit, and any limitations currently in the nexus statute would be eliminated. Critics of this provision have noted, however, that this provision places a level of uncertainty in California's law for out-of-state retailers making sales to California consumers. And, to the extent that California interprets this to include out-of-state retailers with California affiliate programs under this provision, Amazon has confirmed that it will terminate its relationship with its 10,000 California affiliates.
3. **Proposed paragraph (3) of Section 6203(c) would impose a use tax collection obligation on retailers such as Amazon.com LLC, the on-line retailer.** This provision would impose a use tax collection obligation on out-of-state retailers who have certain sister companies in California that perform specified services in cooperation with the out-of-state retailer, as described. Amazon.com LLC (the on-line retailer), for example, and any other similarly organized out-of-state retailer,

would fit within this provision. Amazon.com Inc. is a Seattle-based corporation. The on-line retailer, Amazon.com LLC, is a member of Amazon.com Inc.'s commonly controlled group and a member of Amazon.com Inc.'s combined reporting group under California's Corporation Tax Law. Amazon.com LLC's commonly controlled group has other California-based members that perform various services in this state in connection with items sold by Amazon.com LLC. For example, A9.com is a California-based wholly-owned subsidiary of Amazon.com, Inc. and provides product and visual search technologies for items displayed on Amazon.com LLC's website. Another California wholly-owned subsidiary, Lab 126, performs design and development activities associated with Amazon's Kindle and other electronic reading devices. This change to Section 6203 would specify that such described out-of-state retailers are engaged in business in California, based on the activities of their other members of their commonly controlled group, and are required to collect California use tax on their taxable sales to California consumers. This specific form of nexus has not been reviewed by the U.S. Supreme Court, but it does raise a question regarding whether it would be consistent with the "physical presence" test affirmed in *Quill*. Ultimately, the physical presence requirement for nexus may have to be reexamined by the court to reflect today's marketplace.

4. **What happens if an out-of-state retailer fails to comply with the reporting requirements in the bill?** In light of the preliminary injunction against Colorado's similar provision, and the U.S. Supreme Court cases holding that a retailer must have a substantial nexus in the state in order to be required to collect use tax, it is unclear whether the BOE would ultimately be able to enforce these tax obligation notices and the information reporting requirements. Does information reporting require the same level of presence as a use tax collection obligation?
5. **If out-of-state retailers *do* comply, a potential exists for a substantial amount of information sent to the BOE.** The volume of information the BOE might receive could be significant, and the bill does not require that retailers submit the information in any certain format. At a minimum, the bill should require that the information be submitted to the BOE in a manner prescribed by the BOE.
6. **The transfer of consumer information could cause concern.** A portion of the population is to some degree concerned about threats to privacy with the potential of unlimited exchange of electronic information with their Internet purchases. Many purchasers prefer to make certain purchases via the Internet because they believe they are doing so privately and anonymously. This bill could cause concern of many consumers whose private information and buying habits would now be shared with a government tax agency.
7. **Related legislation.** SB 234 (Hancock) and SB 655 (Steinberg) contain language similar to a portion of this bill that specifies that any out-of-state retailer that has substantial nexus with this state for purposes of the Commerce Clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty is a "retailer engaged in business in this state."

AB 153 (Skinner) specifies that a "retailer engaged in business in this state" includes a retailer entering into an agreement with a California resident under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link or an Internet Web site or otherwise, to the retailer, under specified conditions.

**COST ESTIMATE**

The BOE would incur costs to administer this bill. Enactment of this bill could have an increase in the BOE's workload attributable to identifying and notifying affected out-of-state retailers, registering retailers, amending the BOE's regulation, pursuing collection efforts, and perhaps increased costs related to appeals and litigation. An estimate of these costs is pending.

**REVENUE ESTIMATE**

The revenue impact from the bill's proposed changes is subject to considerable uncertainty. And, there could be an unknown delay of any revenues due to potential litigation. In a purely static world (no behavioral changes resulting from the change in tax policy) with full compliance, we estimate that the proposed changes would increase revenues as follows:

**Nexus Under Federal Law.** In our updated December 2010 e-commerce and mail order estimate, we estimated that the annual state and local revenue loss from unreported use tax associated with out-of-state Internet and mail order sales amounted to \$1.145 billion per year. This measure could expand the BOE's ability to include out-of-state Internet and mail order retailers that are currently not considered as having nexus under current Section 6203, and require them to register and collect use tax from California consumers. To the extent this bill expands nexus to some of those out-of-state retailers not currently required to collect the use tax, the amount of additional revenue could result in between 1% and 5% (\$11 million to \$57 million) of the lost state and local revenue from Internet and mail order sales by out-of-state retailers. As an example, this provision could include out-of-state retailers that use independent California contractors to perform warranty and repair work on products they sell, or those out-of-state retailers currently unregistered that sell the same or substantially similar line of products as the retailer maintaining sales locations in California under the same or substantially similar business name.

In addition, since a New York Appellate court ruled that the affiliate nexus provision is constitutional on its face, we include those related revenues to this estimate. Specifically, our static revenue estimation methodology for this component produces a state and local revenue increase of \$152 million in 2011-12 (a half-year effect) and \$317 million in 2011-12. These estimates are based on the combination of (1) the amount of revenues currently being collected in New York, adjusted for California's larger economy, and (2) increased revenues associated with out-of-state retailers that sell to California consumers on eBay that would have a use tax collection obligation under the provisions of this bill.

However, the State's likelihood of actually realizing these revenues depends entirely on (1) Internet retailers' (such as Amazon and Overstock) willingness to continue their affiliate programs, and (2) other retailers' willingness to continue to sell on eBay and to fully comply with the added use tax collection obligations imposed by this bill. We have received direct confirmation from Amazon that it will terminate its relationship with its 10,000 California affiliates should this measure get enacted. We estimate that Amazon currently comprises roughly 50 percent of the Internet sales of large firms who currently do not have nexus in California. Consequently, the static revenue estimates cited in the previous paragraph, adjusted for Amazon's response, would drop to \$114 million in 2011-12 and \$234 million in 2012-13. If other firms were also to terminate their affiliate

programs in response to the enactment of this bill, the revenue gain would be further diminished. Similarly, while we lack the data to determine to what extent out-of-state retailers would discontinue their use of eBay to sell to California consumers, any drop in such eBay usage would even further lower the revenue gain.

Additionally, the termination of affiliate programs would have an adverse impact on state employment, which in turn would lead to lower revenues from sources such as the personal income tax and the corporation tax. The amount of these potential reductions is unknown.

***Nexus by Commonly-Controlled Group.*** As noted in Comment 3 (on pages 5-6), this provision is intended to impose a use tax collection obligation on specifically structured out-of-state retailers with in-state sister companies performing services related to tangible personal property to be sold by the out-of-state retailer. This would apply to Amazon.com LLC (the on-line retailer) and any other similarly organized out-of-state retailers. The revenues associated with Amazon sales to California consumers are identified in the previous paragraph, and we have no information that would reveal other out-of-state retailers that are similarly structured to determine any further revenue impact. However, this does not mean that there are not other companies that are similarly structured that could be impacted by this provision.

***Information-Reporting Requirements and Penalty.*** Current data from the Franchise Tax Board indicates that 0.36 percent of taxpayers self-report a use tax liability on their income tax forms. If a similar level of compliance is achieved by the bill's Internet and mail-order use tax notification requirements, the state and local revenue gain could be as high as \$10 million. However, the actual level of compliance achieved by the provisions that require retailers to (1) send information about California consumers to the BOE, and (2) send information directly to consumers about use tax owed is unknown.

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